

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51021; File No. SR-FICC-2004-09)

January 11, 2005

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change Relating to Changes to Membership Requirements

On April 14, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”), a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> (File No. SR-FICC-2004-09) and on November 16, 2004, and January 3, 2005,<sup>2</sup> amended the proposed rule change. Notice of the proposal was published in the Federal Register on November 30, 2004.<sup>3</sup> No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

## **I. Description**

FICC’s Government Securities Division (“GSD”) and Mortgage Backed Securities Division (“MBSD”) rules will be changed in the following areas:

### **A. Annual Audited Financial Statements**

Prior to this rule change, GSD’s rules required U.S. applicants for GSD membership to submit annual audited financial statements for the preceding year and non-U.S. applicants to submit annual audited financial statements for the preceding three years. MBSD’s rules used to

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> Although the proposed rule change was amended after it was noticed for comment in the Federal Register, republication of the notice is not necessary because the post-notice amendment made only a technical change to the proposed rule change.

<sup>3</sup> Securities Exchange Act Release No. 50718 (Nov. 22, 2004), 69 FR 69653.

require U.S. and non-U.S. membership applicants to submit annual audited financial statements for the preceding year.

Under the rule change, FICC will amend both divisions' rules to require GSD netting applicants and MBSD clearing applicants to submit two years of annual audited financial statements. However, if an applicant or member has not been in business for two years (i.e., a newly-formed applicant or member<sup>4</sup>), FICC will permit such applicant or member to submit annual audited financial statements for a lesser period and/or annual audited financial statements of a predecessor firm in the case of an applicant or member formed by a corporate transaction. If audited financial statements cannot be obtained, newly-formed applicants will be permitted to submit unaudited pro forma financial statements. If FICC accepts pro forma or consolidated financial statements, the following shall apply:

1. If an applicant is newly formed and does not have annual audited financial statements, the applicant shall be required to submit pro forma financial statements and, if it has filed any regulatory reports, such regulatory reports.<sup>5</sup> FICC will verify the applicant's capital base by reviewing evidence from a third party as to the applicant's capital at the time of application.<sup>6</sup>
2. If an applicant is newly formed as a result of a merger (or similar corporate transaction), the applicant shall be required to submit pro forma

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<sup>4</sup> A newly formed applicant includes a company with no business history or a company formed as a result of a corporate transaction such as a merger.

<sup>5</sup> Unregulated and non-U.S. entities will be required to produce specific information that FICC needs in order to develop a risk profile to evaluate creditworthiness. This information will be requested in a form provided to the firms by FICC and signed by a senior officer of the firm. This form, which was the subject of a proposed rule filing, SR-FICC-2004-14, replaced the requirement for the submission of regulatory reports by non-U.S. entities. Securities Exchange Act Release No. 51018 (Jan. 11, 2005).

<sup>6</sup> For example, FICC may request a bank statement to verify that cash has been deposited, thereby verifying that the applicant meets FICC's minimum capital requirement.

financial statements, the most recent annual audited financial statement of its predecessor firm if such statement is available, and if it has filed regulatory reports, such regulatory reports.

3. If the applicant does not have its own audited financial statements but is consolidated in its parent's audited financial statements and it has filed its own regulatory reports, the applicant shall be required to submit such regulatory reports in addition to the consolidated financial statements.

FICC believes the proposed rule change permitting less than two years of annual audited financial statements or unaudited pro forma financial statements is necessary and appropriate in order to accommodate entities that are newly-formed and those that are created as a result of a merger of existing entities or other similar corporate transaction. First, firms that are newly-formed do not have audited financials and in some instances can only provide pro forma financial statements. Second, the GSD's rules already contemplate the admission of entities with little or no business history, which often are of equal or even greater credit quality than more established entities. For example, GSD's rules provide that a netting applicant must have an established, profitable business history of a minimum of six months or personnel with sufficient operational background and experience to ensure in the judgment of FICC's Membership and Risk Management Committee the ability of the firm to conduct its business.<sup>7</sup> Third, FICC believes that the foregoing information will provide sufficient evidence that the applicant meets FICC's membership standards. Upon approval for membership, such a firm will be required to submit interim financial data to FICC, which will be used to monitor adherence to FICC's established financial parameters. As of its fiscal year-end, the firm will be required to provide its annual audited financial statement. At that time, the applicable interim statement will

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<sup>7</sup> FICC Rule 2, §4 and Rule 3, §2(c).

be compared to the audited financial statement. If there are discrepancies, the firm will be required to supply FICC with an acceptable explanation.

B. Financial Statements Prepared at the Applicant or Member Level

Prior to this rule change, the rules of both FICC divisions specified that all required audited financial statements be prepared at the applicant or member level. However, some entities do not prepare their own audited financial statements. Their financial status is included in audited consolidated financial statements of a parent company.<sup>8</sup>

FICC will amend both divisions' rules to permit the submission of audited consolidated financial statements in situations where audited financial statements are not prepared at the applicant or member level. First, many members are not required to prepare their own audited financial statements by their regulators and doing so would be very expensive. Second, FICC is comfortable in accepting audited consolidated financial statements because FICC is able to obtain information regarding an applicant's or member's financial status through interim financial data on the applicant or member itself. This interim data is on the applicant or member firm level and is obtained from regulatory reports filed by the applicant or member itself or unaudited financial reports prepared internally by the applicant or member. FICC staff compares data from the applicable interim statement to the audited financial statement or applicable audited consolidated financial statement. If there are discrepancies, the firm would be required to supply FICC with an acceptable explanation. In addition, in instances where the member or applicant is unregulated and regulatory reports are thus not available, FICC may request

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<sup>8</sup> References to a "parent" company can mean a direct parent, intermediate parent, or ultimate parent company.

consolidating financial statements from the member firm, which will show the financials of the entities that were included in the audited consolidated financial statement.

In addition to this change, FICC will make a technical change to the term “financial statements” in GSD Rule 2, Section 7, to update the current reference to “shareholder’s equity” to “owner's equity” to encompass those entities that do not have shareholders.

#### C. Compliance With Certain Capital Requirements

Before this rule change, GSD’s rules stated that a comparison-only applicant must be in compliance with the capital requirements imposed by its designated examining authority, appropriate regulatory agency, or other examining authority or regulator, and any other self-regulatory organizations to which it is subject by statute, regulation, or agreement. FICC will eliminate this requirement because comparison-only membership does not present FICC with any credit or financial risk since FICC does not guarantee that service.

#### D. Letters of Credit

GSD’s rules used to provide that if an approved letter of credit issuer was a non-U.S. bank acting through a branch or agency in the U.S., it was required to provide FICC with a “guarantee of performance” of such branch or agency deemed sufficient by FICC. FICC believes that the current language needs to be clarified because it was never meant to require a financial guarantee. FICC believes that it is not appropriate to require the head office of an approved letter of credit issuer to provide a financial guarantee for its branch or agency, given that the latter is simply an “arm” of the head office itself and not a separate legal entity.

Accordingly, FICC will change the current language to specify that non-U.S. banks wishing to become approved letter of credit issuers must have language in their opinion of counsel indicating that the head office is “ultimately responsible” for the credit obligation of the

branch or agency. This language is already contained in the pro forma legal opinions that are part of the FICC letter of credit issuer application.

## **II. Discussion**

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in its custody or control or for which it is responsible.<sup>9</sup> The rule change will harmonize both of FICC's division's application requirements and will make clear to all applicants and members of the breadth of financial information that FICC will require and review in order to develop an accurate risk profile to evaluate an applicant's or member's financial responsibility. Accordingly, the proposed rule should assist FICC mitigate financial risk to itself and to its members and therefore should help FICC to assure the safeguarding of securities and funds which are in its custody or control or for which it is responsible.

## **III. Conclusion**

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act<sup>10</sup> and the rules and regulations thereunder.

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<sup>9</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>10</sup> 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2004-09) be, and hereby is, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

Jill M. Peterson  
Assistant Secretary

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<sup>11</sup> 17 CFR 200.30-3(a)(12).